

RICHARD RUSSELL'S DOW THEORY LETTERS, INC.

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LETTER 714

Nov. 4, DJIA 809.94; PTI 759; A-D Ratio -22.18
Nov. 11, DJIA 845.82; PTI 790; A-D Ratio -20.38

BACK TO PROBABILITIES: There are times when I can say something really definite and emphatic about the market. Something has occurred which leaves almost no doubt about its meaning. There are other times when the picture is hazy or opaque, and at such times all I can give are the probabilities and the odds. You guessed it; this is one of those times when I have to deal with the odds.

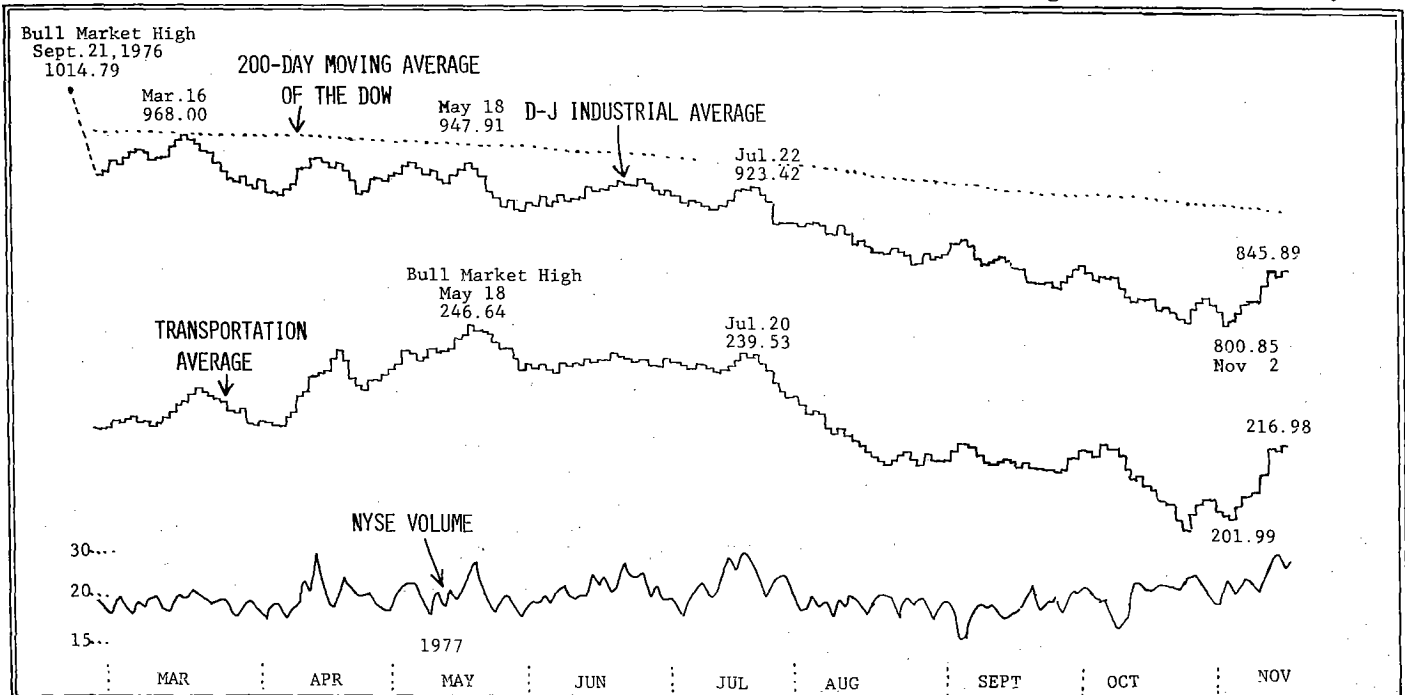
I'll abbreviate the odds. I think the odds are poor that the rally which began November 2 is going to turn out to be a profitable or extended one. I think the odds of an important double-bottom in the Dow 800 area are less-than-fair. I think the odds on the market (or the Dow) going to new lows are the best of the three. I'll amplify these views below.

APPRAISING THE MARKET: The D-J Industrial Average hit a bull market high on September 21, 1976 at 1014.79. Following that peak, the Dow declined steadily to the 800.85 low of November 2, 1977. This meant that the Dow had retreated for 13 months in a row, and lost 214 points in the process. But the extraordinary thing about the decline was that it continued without so much as a 5% intervening rally. Nothing like this has been seen in stock market annals.

Then the situation changed. From the 800.85 low point of November 2 we witnessed an extraordinary, high-velocity rally. In the course of 7 trading days (November 2 to 11) the Dow exploded 45.04 points to 845.89. This meant that in 7 trading days the Dow Industrial Average recovered 21% of the losses sustained over 13 months of decline! This is action typical of a rally in a bear market rather than an advance in a bull market. But it did accomplish one thing—it gave us the first “over 5%” rally in the the Dow for 1977.

Readers of these reports could hardly have been shocked by the early November “upside-explosion.” In the last Letter I stated that there were four items which interested me about the action at the late-October to early-November lows. Here are the four items again: (1) The low for the Dow during the entire 1976-77 decline was struck on November 2 at 800.85. But despite intraday lows down to 792, the Dow **never** closed below the critical 50% level of the 1974-76 bull market advance. (2) There was a minor non-confirmation at the lows, a non-confirmation which materialized when Transports refused to confirm the last dip of the Dow to the 800.85 point. (3) My Fibonacci work pin-pointed the month of *October*, 1977 as an important one (perhaps a month for the turn to the upside). (4) The longer the Dow decline carried without a 5% or more rally, the better the odds that any rise would be the beginning of the long-awaited rally. In other words, there was a limit as to how long the string of uncorrected down-months could stretch without a decent rally. All these represented plusses in favor of at least some upside fireworks.

As long as I have listed the near-term plusses which (I think) produced the rally, I feel I should also list some of the market negatives which exist at this time. (1) Just as too many analysts became too pessimistic at the Dow 800 lows, too many advisors now are announcing that “the bottom has been seen” (personally I'm not convinced). (2) The recent rally did not start from anything resembling an over-sold bottom. (3) The odd-lotters were **decreasing** their selling right through the bottom and they have continued to swing toward buying. Most bottoms are struck amid increasing odd-lot pessimism, not rising optimism. (4) Huge volume accompanied the rally. Most major advances are not so well-advertised at the onset. (5) The monetary segment of the market continues to look long-term bearish to me. All my money



charts have *tops* on them. (6) The rally took the NYSE Composite Index back to the breakdown point (at 52.50) where there was very heavy supply. The NYSE Index promptly **dropped back below 52.50** (where it is now).

What happens next? The market could continue to push up from here. It could back-and-fill, consolidate, muster its forces, and try for say the Dow 875 area. My own feeling is that this market will be hard pressed to extend the advance from this area. My various indices are becoming over-bought, general sentiment is becoming "hopeful," and already there is talk about a "big year-end rally." Maybe so, but I'm becoming increasingly skeptical.

Second possibility: Unfortunately, the rally that began from 800.85 on the Dow began from a sharp "V-base" which means there was no broad bottom, no extended testing, just an explosion off the lows. If there is to be a decent year-end rally the least I would expect would be a testing of the 800.85 low on the Dow and an "impressive" double bottom. If the market turns down here, the downside points to watch are clear enough. They are the November 2 Dow low of **800.85** and the October 25 Transport low of **199.60**. The operative rule is this: if, on a testing of the lows, **ONE OR BOTH** Averages hold above their respective lows, then we would have the first impressive-looking price pattern in over a year. In that case, I would almost surely recommend "pilot purchases" of stocks for an advance which would have the potential to generate some real profits.

IF we get a return to a double bottom around Dow 800, I don't know if a fully over-sold market condition will be registered. But at least there would be a chance for an over-sold. An important non-confirmation, in my opinion, could at least generate enough technical strength to produce a good year-end rally.

All right, here's the final possibility, and it's one that I would by no means write off. I'm talking about a deep final leg down by the market, one that would take all the major Averages and indices to new lows. Such a plunge would be sure to carry the market (amid panic conditions) down to a fully over-sold condition. I have a suspicion, and it's only my personal suspicion, that this is what we are fated to see in the period ahead.

Obviously a slide such as the one I am talking about would entail a Dow breaking of the 800.85 level, confirmed with a Transport cracking of 199.60. We could expect to see heavy volume on a final down-leg and a tremendous rise in pessimism and gloom. But to my mind, pessimism is the element that has been **lacking** on the entire 1976-77 decline. If history is any criterion, rampant pessimism should materialize before this market develops an **IMPORTANT** bottom.

I haven't mentioned the Utility Average in a while, and I want to say something about this bellwether group now. The Utilities tend to lead the market on many movements, both during advances and declines. For this reason, we might watch this interest-sensitive group now. The Utility Average hit its bull market peak of 118.67 last July 22. It then sank to an Oct. 25 low of 108.71. But on the recent rally, Utilities pushed no higher than 113.06 (Nov. 14), a rise of 4.1%. This was less of a rise than that of either Industrials or Transports.

On my point and figure chart a Utility rally to 115 would be a bullish signal for the Average, while a decline to 108 would represent a distinctly bearish signal. It will be well worth watch-

ing the Utility group over the next few months for indications regarding the direction of both the market and interest rates.

It's remarkable how the consensus changes. A few months ago "everyone" was sure interest rates were going higher in 1978. Now the same experts tell us interest rates are topping out. My own view—I still think we're going to see higher interest rates next year—with or without Mr. Burns.

I want to go into a few other facets of the market picture at this time. First, the odd-lot transactions have been unsatisfactory all along. On the decline to Dow 800.85 the odd-lotters were decreasing their selling, which means that they were taking the decline as "a chance to pick up bargain stocks." Then on the advance the odd lots continued to decrease their selling, meaning that they felt "the bottom had been seen." The odd lots eventually get with any extended trend, but they are usually **wrong at the turns**. If we get a second approach to Dow 800 and it finds the odd lotters increasing their selling, I would take that as a sign of technical strength.

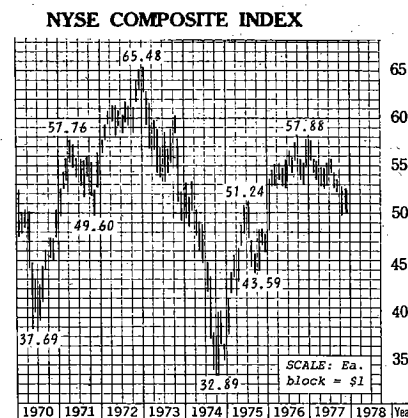
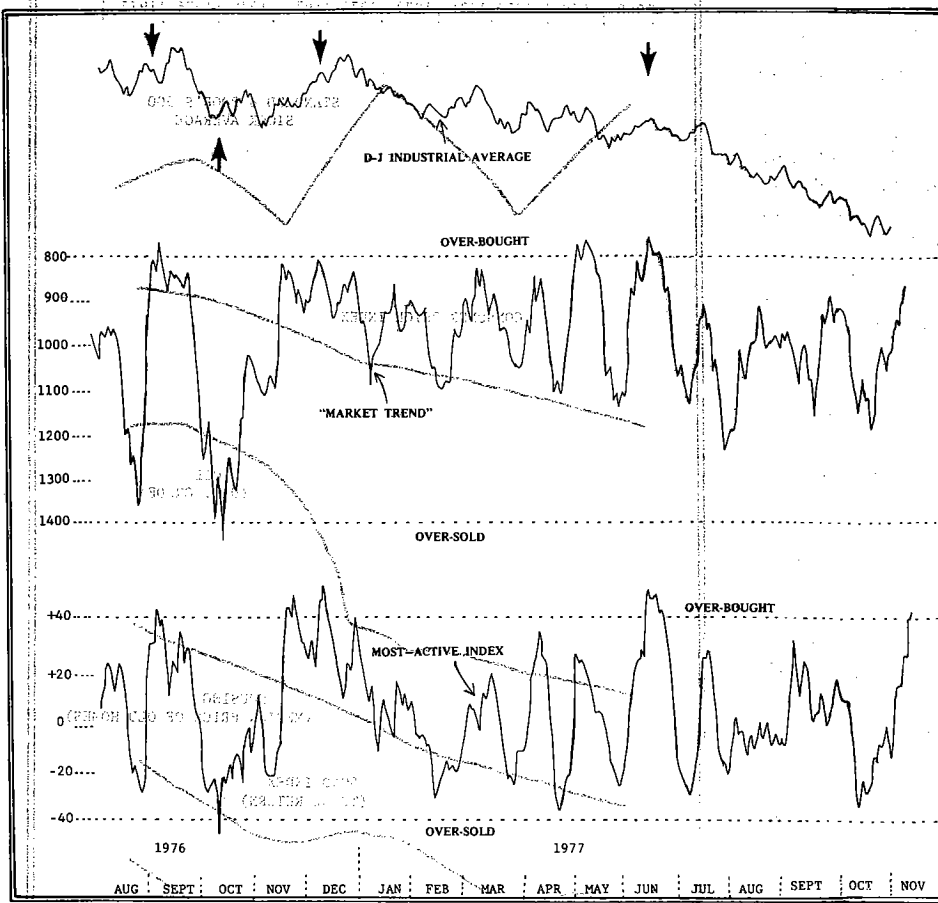
A study of the so-called "decennial pattern" shows that there is a strong tendency for the market to be down in "7 years" (i.e., 1937, 1947, 1957, etc.). There is also a tendency for the market to be up in "8 years." There is a further but more subtle tendency for the market to decline during the *early* part of an 8 year, but then to advance throughout the rest of the 8 year. This latter sequence occurred in 1918, 1928, 1938, 1958 and 1968. The variation was 1948, which saw the usual slide during January and early-February, then a big advance to June, but in June the market topped out.

The decennial pattern therefore puts us on alert for irregularity or a decline early in 1978 with a good advance carrying through the remainder of the year. To put it all in the present context, one thing that would bother me is a possible further market rise from here through December. Such a rise, in the absence of an over-sold bottom, would be very apt to top out in late-December, preparatory to a decline to an early 1978 bottom.

The Dow declined for 13 months, and obviously any decline eventually must halt. As a rule, when the market is in a major declining phase, the price movement becomes more violent as the ultimate bottom is approached. November has produced the first signs of violence since the Dow began sinking. One thing abrupt rallies accomplish (even if the market is to go lower) is put the brakes on the downward momentum. To this extent, no matter what happens in the period ahead, I think it is a good sign that we are finally getting real rallies in the Dow. "Spike" rallies may not represent ideal upside action, but they do result in a breaking action on the descent.

The three moving averages (MA's) of the Dow now stand as follows: the 4-week MA is at 826, 13 points below the 13-week which is at 839. The 13-week in turn is 70 points below the 50-week MA, which stands at 909. A buy alert would be given if the 4-week pushes above the 13-week MA.

My over-bought and over-sold indicators are as follows: the "market-trend" index is around 890, in the area I would term semi-over-bought. The most-active stocks index is in the over-bought area at plus 41. These two indices could conceivably stay over-bought for a while, but they show the market starting to strain on the upside (see chart on page 3).



Here's a monthly NYSE Composite / chart courtesy of *Horsey, Salisbury, MD 21801*. Note the size of the top which has formed in this broad index during 1976-77. The recent rally took the price movement back to the bottom of the top formation, where increasing resistance was seen as the Index pushed temporarily above 52.50. This immense "upside resistance" probably explains why volume was so high during the early November rally. It takes massive volume to chew into a top of the size seen on this chart.

ELLIOTT: Many subscribers have written asking what I think of the current market in terms of the Elliott Wave Principle. I last reviewed the picture in Letter 691 and 697, and this seems like a good time to bring the Elliott interpretations up to date.

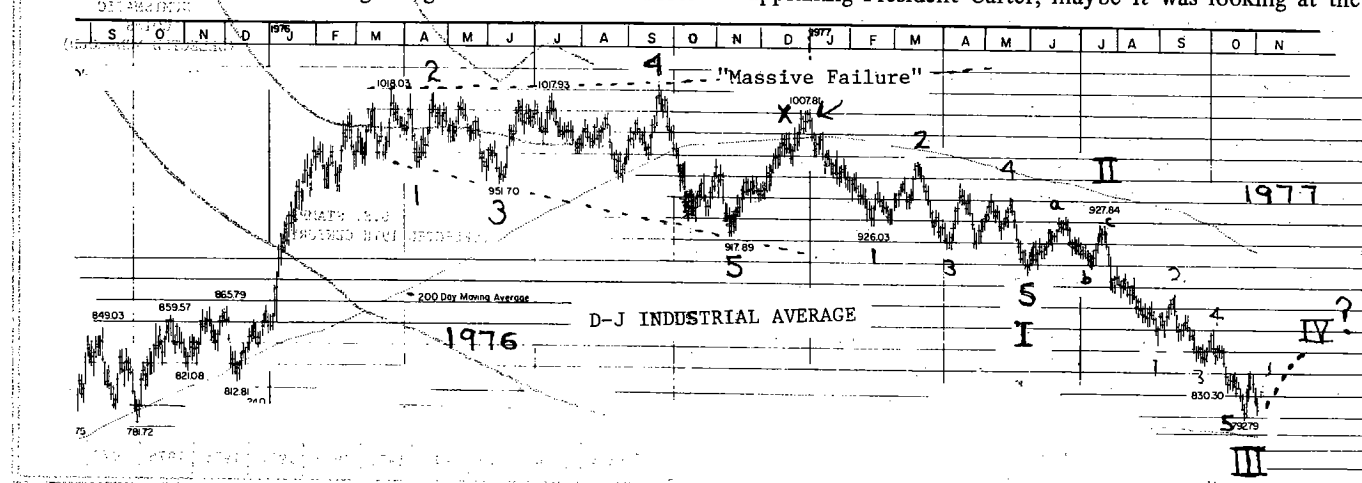
The last thing I discussed (Letter 697) was a phenomenon which I termed an important "upside failure" for the Dow in late-December, 1976. That incident was a dramatic failure by the Dow to push above its previous market peak of 1014.79 (Sept. 21, 1976). I wrote in Letter 697: "But the failure at 'X' on the chart implies weakness, and I am doubtful as to whether the Dow is capable at this time of making a new bull market high above the 1014.79 high of September 21, 1976."

I have included an updated chart of the daily Dow action, and I think the whole situation is beginning to take form in Elliott

terms. During 1976 we had a giant "consolidation-correction" which took the form of a one-year triangle. This triangle (a triangle is always a corrective pattern) is shown on the chart as a 5-point triangle, and the triangle is contained by the two dotted trendlines.

Following point 5 at the November, 1976 low, the correction was completed. From here, the normal expectation was a major new bull leg, an up-wave which should have corresponded with the speculative third phase of the bull market. But at X (Dow 1004) the price movement fizzled. The Dow simply "died." This extraordinary failure under Elliott went a long way towards turning me cautious at the time.

I didn't know why the Dow failed at X. Maybe the market was appraising President Carter, maybe it was looking at the dollar



and the deficit situation, I don't know. But I do know that something "changed," and the Dow produced an amazing Elliott failure on the upside, then turned down.

Since that failure in December, 1976, the Dow has moved down in which is either a major Elliott correction or an Elliott bear market. I show the Dow as having completed two major downward legs and one corrective rallying leg. The completed legs are marked in Roman numerals. Leg I carried down to a May 31, 1977 low. Leg II then rallied the Dow to a July peak. Leg III, then slammed the Dow down to the recent October 25 low of 801.54.

The big question, of course, is this: "Have we completed a 1-2-3 Elliott correction? Or is the most recent rally part of upward corrective leg IV, the preamble to downward leg V which will finish off this phase of the pattern?"

As this is written, there is really no way of my telling whether the advance that began on November 2 is going to develop into (1) a more extended (upward) corrective leg IV, or (2) whether the November 2-11 rally completed a sub-standard upward leg IV, or (3) whether the market will come down and trace out a double bottom, preparatory to a much more extensive upward leg IV. All that remains to be seen, and there is no sense guessing about it at this stage of the game.

PRICES: I often hear supposedly learned gentlemen talking about the ins and outs of various investments. They go into a thousand ramifications and theories, and I say to myself, "Give me indices, give me the price movement. All the talk and arguments and expertise in the world isn't as interesting to me as the price movement. That tells me what I want to know."

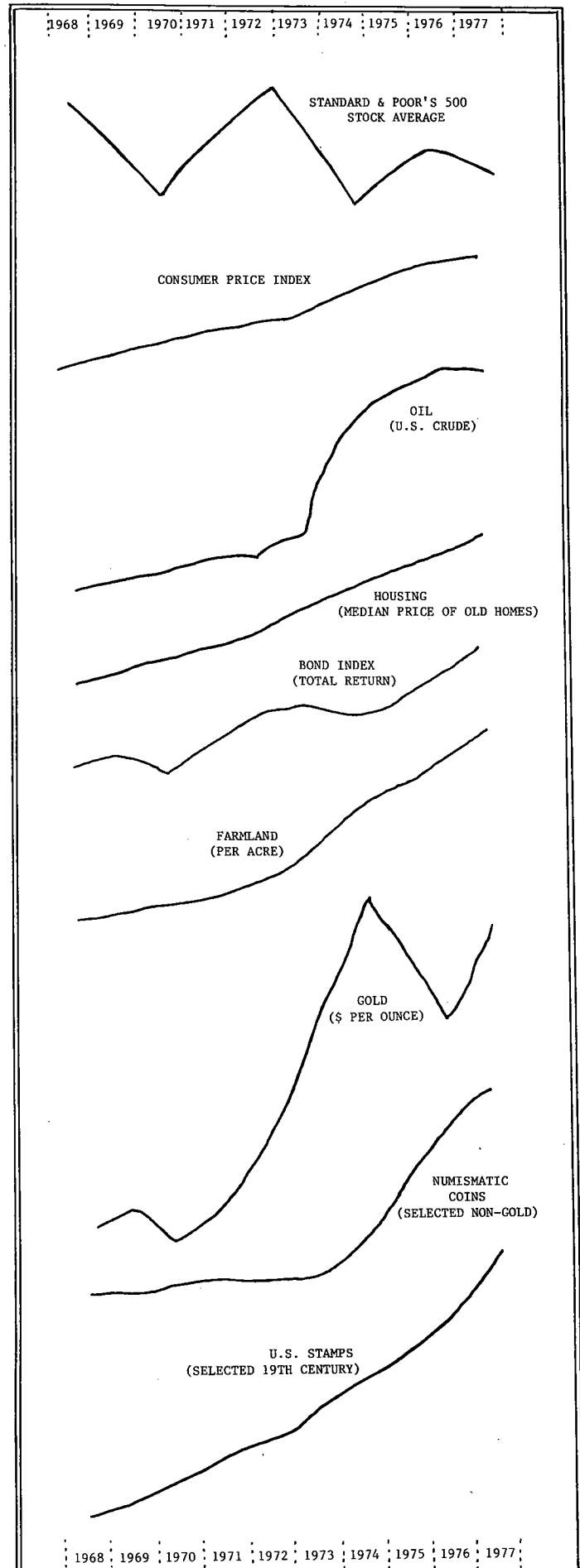
Over the past six months I have laboriously put together a series of nine widely followed segments of the investment world. I don't want to include a lengthy discussion of each, but I will include a few comments.

All these indices are drawn to semi-logarithmic (ratio) scale, so they can be compared in terms of percentages. In fact, if you want to see whether one index is doing better than another, all you have to do is place one end of your ruler at the 1968 price and the other end at the 1977 price. The slope of your ruler will tell you the story. For instance, the only downslope on the chart is the S&P 500 Stock Average. That downslope tells you that you lost money holding the average portfolio of stocks through the 1968-77 period. And I am not even factoring in the losses that you would have sustained through inflation.

The steepest slope on the chart is the one profiled by gold. Even with the 1974-76 gold bear market, the man who bought \$35 gold in 1968 and held it until today would have an appreciation of 380% at this time. The second biggest in terms of price appreciation is 19th Century US postage stamps. The 1968 to 1977 average appreciation in selected good quality postage stamps amounted to around 270% (this does not include the possibly large commission involved in buying and selling stamps).

In all fairness to the Arabs, note that the recent huge rise in the price of oil is mainly a "catch up" situation and one that simply puts oil basically *in line* with other items.

Three of the items, farmland, coins and stamps, differ from the other items in that they are limited in world quantity. In other



words, there is just so much land in existence, and there are just so many 1893 Columbian stamps sets in existence. Therefore, we have had a situation in which an increasing number of buyers have been chasing a limited quantity of the items, and this is always explosive on the upside. Interestingly, of all the items shown here, only the stamp category has never suffered a serious downside correction in the past 40 years.

THE PICTURE: Last week I received a call from a good friend who has been in the securities business as long as I have. He is a partner in a small, well-financed brokerage house. "How do you feel about things?" I asked him. "Tired," he said, "just plain tired. For the first time in years, I don't know whether to do something, do nothing, buy or sell, sit or stand."

I've been getting more letters over the past few weeks than ever before. I would say that most of these letters have to do with argument against my position than anything else. Readers tell me that it's still a bull market, that they don't understand my bearish position, that the market is losing downside momentum, that we could be on the edge of a big advance (if not the actual "third phase" of the late bull market).

In my opinion the market may produce rallies, it may retrace a part (conceivably even a large part) of the 1976-77 bear market losses, but I believe the primary trend expired, fizzled out, somewhere around the latter part of 1976, as the D-J Industrial Average tried (unsuccessfully) to better the 1014.79 peak. I think the market looked ahead as far as it could see, and it didn't like what it saw, it didn't like it at all—and the bull just expired.

There are a few things which I'm reasonably certain about at this point. (1) I'm reasonably certain that the US is going to produce whopping deficits next year. I see a built-in deficit of \$40 billion or more. (2) I'm reasonably certain that business is not going to be particularly exciting next year. It may not be bad, but I don't think it is going to be good. Couple that with probable rising unemployment, and I'm reasonably certain that Carter is going to ask for (and get) a tax cut. (3) I'm reasonably certain that we're also going to have *monetary* inflation next year. We may not get higher prices (i.e., price inflation), but we will get continuing inflation on the dollar front. Thus, on a long term basis, I believe we'll see the dollar continue to slide.

I have written before, and I will repeat, that the primary trend is almost always **international** in scope. Whereas an individual nation may have its own recession and accompanying market reaction, when it comes to the primary trend almost all the nations of the Free World are "in it together."

I have included charts of 12 major foreign stock markets (courtesy *Int'l Bank Credit Analyst*, Butterfield Bldg, Front St, Hamilton, Bermuda). I have drawn in my own trendlines, and here is what I see:

Of the 12 indices, 9 are in clearly established downtrends. The strongest index has been Japan's, but the Japanese index is now cracking below a 12 year trendline. The next strongest indices belong to West Germany and Britain. But Germany has yet to reverse its 10 year downtrend. And the UK has recorded what seems to be a double top and may now be turning down. Sweden is now smashing a rising trendline which has held since 1962.

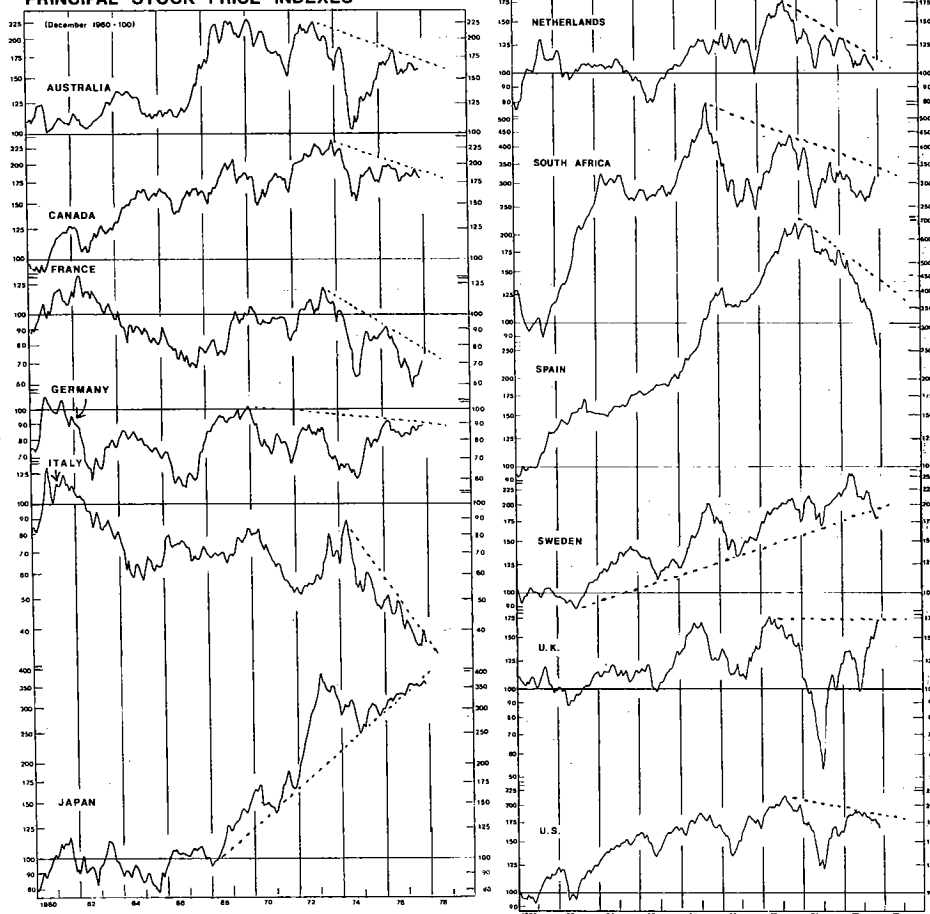
Thus, from the international viewpoint, it would seem that a primary bear market is in force. There are few holdouts against the general bearish tide that is pushing the stock indices of the world to lower and lower levels.

The reaction to the "world slowdown" is predictable. We are going to see a move to re-flate. Already nations such as Germany, Japan, Britain, and Canada have taken reflationary measures, and the US is readying itself for a tax cut. In fact, if we can take the November 14 issue of *US News and World Report* as authority, a US tax cut of around \$20 billion is "in the bag."

If a tax cut is forthcoming, then what I foresee for the US in terms of deficits is little short of horrendous. A budget deficit of around \$40 billion is already conceded by most economists, and this deficit is based on business going along at about current levels. If business weakens (which I think it will), then the tax take by the Government could be far less. But add the \$20 billion tax cut to the \$40 billion deficit and you have a \$60 billion deficit plus whatever shortfall appears!

Multiply this by the number of countries that will be re-flating, and you get a stupendous increase in the amount of fiat currency slated for 1978. This is the prospect I see, and it is one of the reasons I have been so insistent on subscribers owning gold.

PRINCIPAL STOCK PRICE INDEXES



Now another facet of the picture is this. The Arabs are not fools; they see what is happening. A few weeks ago they let it be known that they may ask part-payment for oil in British pounds. They also hinted of another boost in the price of oil. The Arabs are obviously saying that they will not sell oil for 1977 prices denominated in 1977 dollars. The Arabs are saying that the dollar is a weakening currency, and that they are balking at taking any more 1977 dollars unless there is an oil price increase.

But I wonder if the Arabs aren't getting ready to ask for something new—and that new item could be gold clauses in their oil agreements. I wonder if the Arabs aren't preparing the US for something like this: "Look," say the Arabs, "we'll be happy to sell you oil without a price boost, but we want to be protected by gold clauses in all contracts." In that case, the Arabs would be hedged against any amount of US inflation, since the more the dollar is inflated, the higher the price of Arab oil in terms of dollars, and the more dollars the Arabs receive for oil to the US.

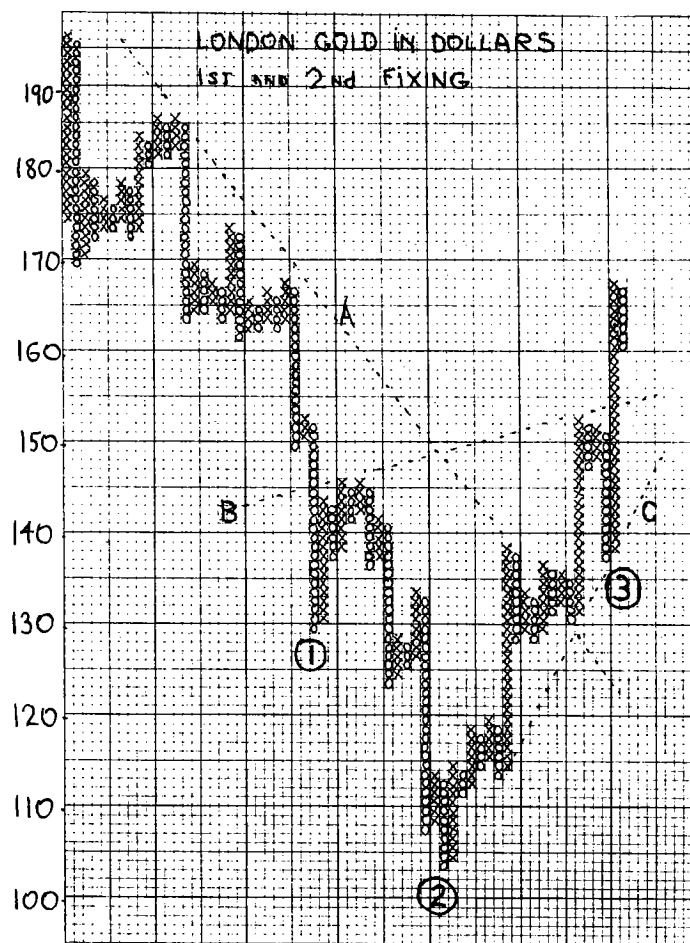
The sad (or insidious) part of the whole collapse of the dollar is that it is systematically impoverishing the American citizen. It is destroying the middle class, because the middle class man can't get the welfare and other Government benefits. It is making a bigger and bigger poverty class, because the poor can't possibly keep up with inflation. And it is insuring the status quo of only that part of the wealthy class that is indexing its assets via gold holdings (the rest of the wealthy class is also losing purchasing power through inflation).

As I showed on the chart in the last Letter, the US is now in the position of trying to run up the "down escalator." No amount of monetary inflation and no amount of budget-deficit accumulations are apt to move the GNP up in any convincing way from here. At this point, inflation does nothing but destroy assets and feed on itself. This process, ultimately, will militate towards a world panic into gold.

GOLD: The mid-East is "quieting down," the Russians are going to sell gold to buy wheat, Fed Chairman Burns may stay, the hard European currencies are "getting tired" of rising against the dollar, any or all of these may be true. But technically, as you can see on this P&F chart of gold, a correction was to be expected. On my chart (each box equals \$1), the last gold rally started at 139 and carried to 168. That represents a rise of 29 points. A 50% correction could take gold back to the 154-56 area, represented by the "breakout" trendline which is labeled "B" on the chart.

For those who have no position in gold yet, any such correction should offer an opportunity to pick up gold or gold coins at what I consider a "good value" basis. For those who do not have as large a gold position as they would like, any set-back to the middle 150's will offer a chance to increase positions.

I don't have room here for my chart of the "trade weighted dollar," which is a daily statistic showing the relative position of the dollar against a basket of 14 other currencies. Two weeks ago, the trade-weighted dollar broke a two-year trendline to the downside, indicating to me that the broad weakness in the dollar is fated to continue—with intermittent rallies against the main downward trend, of course. In the face of the continued deterioration of the dollar, gold represents our "insurance policy." If your 10% to 20% (of assets) in gold never increases in value against the dollar, thank your lucky stars. For that will



mean that inflation has ended, and the money you hold in Treasury bills will look better with each passing year (as will your annual salary). And that's all I have to say about gold and money at this time.

INTEREST RATES: I keep charts of a number of "interest rate items." These include the Utility Average, Government Bonds, GNMA futures, the D-J 20 Bond Average. My feeling is that all of these items have topped out, thereby indicating an intermediate to longer-term swing towards higher interest rates. We had a sudden drop to lower rates over the past few weeks, but I feel that this was just a correction. This is the way I see it, until the charts tell me differently.

LATE NOTES: Ever since September, 1976, it was the D-J Industrial Average which told the story with its remarkable and persistent weakness. That Average could be telling the story again. At any rate, the minor (daily) price movement is interesting at this time. On November 11 Industrials and Transports rallied to peaks of 845.89 and 215.96 respectively. A one-day decline took place on November 14. Then, on November 15 Transports surged up to a new rally recovery high of 216.98. Industrials did **not** confirm.

Ordinarily I would not place any great emphasis on such a minor indication, but it is the *very heavy volume which preceded* this little non-confirmation which adds to the importance of the price pattern. I'm always interested in what the market does when volume is either abnormally heavy or abnormally light. A refusal by Industrials to better the November 11 peak of 845.89 could be meaningful here. Watch carefully to see whether that point is bettered—or not.

NEXT MAILING: November 30th